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TAGS: [ECON](#) [EFIN](#) [ETRD](#) [UK](#) [EINV](#)  
SUBJECT: SQUEEZED IN THE JAWS OF THE CREDIT CRUNCH -- UK ECONOMY  
QUARTERLY UPDATE

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¶1. (SBU) Summary: The British economy will slow dramatically in 2008 and 2009 after leading the G7 with GDP growth of three percent in 2007. Ernst and Young predict GDP growth to fall to only 1.5 percent in 2008, the OECD forecasts 1.8 percent, and Oxford Economics says 1.6 percent. Inflation is running above the Bank of England's target of two percent at 3.8 percent, and demands from unions for higher wages could push it even higher. The employment rate remains fairly stable although there are signs that it may weaken. Ernst and Young predicts the Bank of England will cut interest rates again in November, but any future cuts will depend on inflation. Public finances are in their worst state since 1993. The weakening economy is weighing heavily on PM Brown's reputation as an astute manager of the economy. HMG may be forced to modify fiscal rules he established as Chancellor of the Exchequer and the new Chancellor, Alistair Darling, may be made a scapegoat for economic woes in a fall cabinet re-shuffle. This is the first of quarterly reports on the British macroeconomic situation. End summary.

#### Gross Domestic Product

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¶2. (U) In its quarterly economic forecast, the Ernst and Young ITEM Club forecasts UK GDP growth to fall to one percent in 2009 as the economy 'flirts with recession'. The forecast says the UK economy is in danger of 'being crushed between the jaws of world credit and commodity markets, with little prospect of early relief'. Oxford Economics, a consultancy firm, is more optimistic. It forecasts UK growth at 1.6 percent in 2008 and 1.6 percent in 2009. It has revised down its previous estimates of 1.8 percent and 1.7 percent respectively.

¶3. (SBU) HM Treasury (HMT) expected the financial markets to recover more quickly when they announced their annual economic growth forecasts in their March 2008 budget report, according to Chris Kelly, Senior Economic Advisor at HMT. At that time, Darling predicted the UK's economy would grow between 1.75 and 2.25 percent in 2008 and recover in 2009. Since then, Darling has admitted that his forecast will be revised downward.

4. (U) GDP rose by 0.3 percent in the first quarter of 2008, and is 2.3 percent higher than Q107. Output of the production industries fell by 0.2 percent, compared with a rise of 0.2 percent in the previous quarter. While manufacturing output saw growth of 0.4 percent, it was more than offset by falls in energy extraction and supply. Growth in the services sector was 0.3 percent, down from 0.6 percent growth in the previous quarter. Household expenditure rose 1.1 percent, up from 0.4 percent in Q407. Government final consumption expenditure rose by 0.9 percent.

Figures show real quarterly growth and are seasonally adjusted

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Q107 Q207 Q307 Q407 Q108

GDP 0.8 0.9 0.6 0.6 0.3

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Inflation Above Targets  
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15. (U) ITEM expects CPI to remain above the Bank of England's target range of 1-3 percent for the next 12 months. It predicts that inflation will average 3.5 percent in 2008, coming down to 3 percent in 2009 and 2 percent by 2010. It notes that this forecast assumes that wage and domestic cost inflation remain subdued. In the UK there is currently a significant push for higher wages to offset price increases. This pressure is particularly acute in the public sector where pay increases have been held below those in the private sector and below the cost of living for two years. Chancellor Darling has called for pay constraint but unions are threatening a season of industrial action if pay deals are not reopened. ITEM urged the government not to accept any excessive public sector pay demands which could put severe pressure on any attempts to dampen inflation and potentially destroy any hopes of a medium term recovery.

16. (U) During the first quarter of 2008, the largest upward pressure on inflation came from food, mainly meat, vegetables, and non-alcoholic beverages, and fuel, particularly heating oil. Despite growth in the CPI, however, the UK inflation rate is below the provisional figure of 4 percent for the European Union as a whole. The main factors affecting the CPI also affected the RPI. However, the Retail Price Index experienced a downward contribution from housing. This came mainly from mortgage interest payments as lenders passed on April's quarter point decrease in the bank rate to customers, in addition to house price depreciation.

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(Annual inflation rates - 12 month percentage change)

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Jan08 Feb08 Mar08 Apr08 May08 Jun08

CPI 2.2 2.5 2.5 3.0 3.3 3.8

RPI 4.1 4.1 3.8 4.0 4.3 4.6  
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Employment Stable  
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17. (U) Overall employment and unemployment figures have remained fairly stable, despite volatility in the economy. The total number of people in work rose in the three months to May to an all time high of 29.59 million. However, the number of people in the UK claiming unemployment benefit saw the biggest jump in 16 years. The claimant count has risen by 45,000 since the end of January 2007, to 2.6 percent of the working age population. Job losses are most prominent in the building and financial sectors.

18. (U) Professor David Blanchflower, a member of the Bank of England's Monetary Policy Committee who has voted for interest rate cuts for the last nine months, has predicted that the UK is heading for a recession which could cost hundreds of thousands of jobs. He expects unemployment to rise from 5.2 percent to more than 7 percent. While ITEM is forecasting a rise in the overall numbers of unemployed, it remains hopeful that it will only be a modest jump, particularly in comparison with previous downturns. A major contributory factor to the limited nature of this increase is that poorer UK employment and economic prospects, combined with a weaker exchange rate, is causing a reversal in migration flows. However, it still anticipates that unemployment will rise from 1.6 million at the end of 2007 to the 2 million mark by 2010.

Seasonally Adjusted (Percentage)

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Q107 Q207 Q307 Q407 Q108

Employment 74.3 74.4 74.4 74.7 74.9

Unemployment 5.5 5.4 5.4 5.2 5.2  
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Interest Rate, Pulled Both Ways, Doesn't Move  
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¶9. (U) The Bank of England's Monetary Policy Committee (MPC) has resisted calls to cut the interest rate as the economy continues to falter. With inflationary expectations rising in line with headline inflation figures, the MPC has felt unable to offer relief from a lower base rate. However, ITEM expects a slowdown in consumer spending to pave the way for a rate cut this winter, perhaps as early as November. Beyond that, interest rate decisions will likely be determined by the behavior of commodity prices. If crude oil prices follow the expectations of the futures market and peak at \$150 a barrel this fall, before easing back, ITEM expects interest rates to fall back to 4 percent by the end of 2009. This will help to put a cushion under the level of demand in the economy and set the scene for recovery in 2010.

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Jan08 Feb08 Mar08 Apr08 May08 Jun08

Bank Rate 5.50 5.25 5.25 5.00 5.00 5.00  
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Public Finances Breaking the Rules  
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¶10. (U) HMG's current budget deficit in May, at GBP 9.1 billion, was the worst May figure since monthly records began in 1993, and the second worst figure on record. Tax receipts in the first two months of the fiscal year (which begins in April) were up only 3.6 percent year on year, worse than the 4.8 percent forecast by the Chancellor in his March Budget. The Chancellor has predicted public sector net borrowing to reach GBP 43 billion at the end of the financial year, but analysts believe he will exceed this target by a substantial margin.

¶11. (U) There has been media speculation, widely regarded as accurate, that Treasury officials have begun working privately on plans to rework the fiscal rule, established by Gordon Brown as

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Chancellor, that limits public sector debt to 40 percent of national income. Following the rule changes, it is likely that public sector debt could rise to 42-45 percent of GDP. At a Downing Street press briefing, the Prime Minister's spokesman noted that according to the IMF's latest estimates for 2008, the UK is in a stronger position than most countries. Net debt in the Euro area as a percentage of GDP is currently 55.9 percent and in the U.S. is 47.9 percent.

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Apr08 May08 Jun08

Current Budget (Billions) 0.6 (9.1) (7.6)  
(Deficit in brackets)

Public Sector Net Lending 0.5 (11.0) (9.2)  
(Billions-Borrowing in brackets)

Public Sector Net Debt 36.5 37.2 38.3  
(Percentage of GDP)  
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Chancellor to Pay the Price?  
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¶12. (SBU) Darling threatened to resign twice prior to publishing the

2008 HMT budget report, according to recent reports in the media. One influential MP told us that a shake-up of Brown's cabinet is very likely in the fall, confirming press reports. Darling could likely lose the Chancellorship in any government re-shuffle, given Brown's need to demonstrate a response to the growing public perception of economic malaise in the UK. Darling has also been the point person in multiple unpopular tax proposals that were later revised or scrapped, including the non-dom tax changes, car taxes, and most recently a tax on passive income for multinational firms. The constant reversals have battered Darling's and the government's reputations as responsible guardians of the British economy.